



State of Washington Office of Insurance Commissioner

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A Report to the Legislature: Insurance Credit Scoring

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Executive Summary

In 2002, the Washington State Legislature passed one of the toughest credit scoring laws in the nation. The law applies to personal auto and homeowners' policies. ESHB 2544 changed how insurers use credit history in Washington State. After January 1, 2003, insurance companies could not use credit history to cancel or non-renew a personal insurance policy (primarily auto and homeowners insurance). In addition, insurers cannot use the following attributes of credit history to deny insurance coverage:

- The absence of credit history;
- The number of credit inquiries;
- Collection accounts identified as medical bills;
- The purchase of a vehicle or house that adds a new loan to the consumer's existing credit history;
- A consumer's use of a particular type of credit or debit card; or
- The total line of credit available to a consumer.

After June 30, 2003, insurers could not use most of these factors to set premiums. The one exception – insurers can use the absence of credit history to set premiums if they provide statistical data that proves consumers without credit histories are more likely to file claims. Other consumer protections in the law include:

- Retroactive correction of premium if an insurer uses incorrect credit history for rating or underwriting; and
- Enhanced notice requirements so that consumers know what items in their credit history are affecting their insurance premiums.

Much has changed relative to insurance credit scoring since Washington's law was enacted. Many other states have acted to restrict how insurers use credit history. At least 32 laws have passed in the last two years related to insurance credit scoring.

Commissioner Kreidler serves as co-chair of the National Association of Insurance Commissioners Credit Scoring Working Group (CSWG). The CSWG has worked to educate regulators and legislators on effective ways to regulate insurance credit scoring and developed tools to educate consumers.¹

In January 2003, the Commissioner reported to the Legislature that insurance credit scoring might have unequal effects on some minority groups when compared to whites. Washington State has also provided technical assistance to a group of states that will examine whether insurance credit scoring has a disparate or disproportionate impact on minorities or low-income people. The Federal Trade Commission (FTC) will also be looking at this issue.

¹ The NAIC adopted a matrix titled [Analysis of Regulatory Options](#) and a consumer brochure titled [Understanding How Insurers Use Credit Scoring](#).

With its recent reauthorization of the federal Fair Credit Reporting Act (FCRA), Congress has directed the FTC to examine the effects of credit-based insurance scores on the availability and affordability of property and casualty insurance.

The Legislature required the Commissioner to review how the OIC implemented ESHB 2544 and how the law has affected consumers. For the OIC, implementation had several steps. First, the OIC provided information to consumers and insurers about the law. The OIC used its website and communicated with the media to make sure consumers knew what their rights were under the new law.

Second, the OIC published rules to help insurers adjust their underwriting practices and rating plans. The OIC followed up with a technical advisory to remind insurers that they must implement changes to their rating plans before June 30, 2003. Then OIC instituted a “fast-track” filing review process for insurers that needed to revise their rating plans to comply with the law. Eventually, there was widespread compliance with the law.

The implementation process did reveal a technical flaw in the law that the OIC proposes to correct. OIC believes that the intent of the Legislature was to require every insurance organization to file their credit-based rating plans and to provide actuarial support for those plans. Some insurance organizations have argued that the filing requirements do not apply to insurers that offer products through a multi-company distribution network. The OIC recommends the enactment of legislation that makes it clear that entities that sell personal insurance products – regardless of their organizational structure – must comply with the law.

The effect of ESHB 2544 on consumers is hard to measure, for several reasons. First, restrictions on the use of credit history to set premiums have been in effect for about six months. It is too early to draw conclusions. Second, insurance credit scoring is only one factor insurers use to set insurance premiums.

Insurance credit scoring remains controversial. OIC received about 3,000 contacts from consumers about insurance credit scoring in 2003. Based on these contacts, the OIC has these observations:

- Cancellation and non-renewal due to credit history - one of the primary complaints of consumers in 2001 and 2002 – is no longer an issue in Washington State.
- Consumers are more aware that insurers use credit history to make pricing decisions.
- The “adverse action” notices provided by insurers to consumers need improvement. Insurers and vendors of insurance scoring models must work harder to provide useful information to consumers that explains how and the extent to which credit history affects insurance prices.
- The confidentiality of insurance scoring models inhibits the ability of the OIC to help consumers understand insurance credit scoring.

Introduction

In 2002, the Washington State Legislature enacted ESHB 2544.² This law restricts the use of credit history in personal lines insurance underwriting and ratemaking. The most common types of personal lines insurance are auto and homeowners insurance.

ESHB 2544 had a two-phased effective date:

1. Underwriting restrictions (denial, cancellation, or non-renewal of an insurance policy) took effect on January 1, 2003.
2. Rating restrictions took effect on June 30, 2003.

In response to the continuing debate regarding the validity of insurance credit scoring as an underwriting and rating tool and concerns about the impact of credit scoring on protected classes of people and the poor, the Legislature directed the Commissioner to provide two reports. The Commissioner delivered the first report to the Legislature in January 2003.

Summary of the First Report

The first report³ was a review and analysis of insurance credit scoring including these topics:

- Based on demographic factors, the types of consumers who benefit from or are harmed by the use of credit history in personal insurance rating and underwriting.
- The extent to which the use of credit history affects rates charged to consumers.
- Whether insurance credit scoring results in discrimination against a protected class of people or the poor.

Washington State University Social & Economic Sciences Research Center (SESRC) prepared the first report. The SESRC report found several significant demographic patterns when insurance credit scoring was used in personal insurance underwriting and rating, including:

- **Age:** SESRC concluded that older drivers have better insurance credit scores and, as a result, lower insurance rates.
- **Income:** SESRC concluded that credit scores and, consequently, insurance premiums, improve as incomes rise.
- **Ethnicity:** While SESRC could not draw broad conclusions about ethnicity, SESRC did observe that if minorities had significant premium differences from whites, the premiums tended to be higher. This observation did not apply to Asian/Pacific Islanders.

² http://www.leg.wa.gov/pub/billinfo/2001-02/House/2525-2549/2544-s_sl_04092002.txt

³ http://www.insurance.wa.gov/publications/news/Final_SESRC_Report.pdf

- The SESRC analysis also considered gender, marital status and location and found that premium differences based on insurance credit scoring were infrequent.

Scope of Second Report

This document is the second report requested by the Legislature. It will:

- Comment on current issues related to the use of credit history in personal insurance underwriting and rating;
- Review how the OIC implemented ESHB 2544; and
- Comment on how ESHB 2544 has affected consumers to date.

History

Use of Credit History in Insurance Underwriting and Rating:

The use of credit history in insurance underwriting and rating has been the subject of increasing discussion and debate throughout the United States. The consumer lending industry has used credit scoring since the 1980s to predict whether a borrower would repay a loan. In the early 1990s, insurers began to use credit history to underwrite auto and homeowners insurance. Later in the decade, insurers began using credit history to set insurance prices. Most of the “personal lines” insurers (auto and homeowners) in Washington State currently use insurance credit scoring for rating and/or underwriting purposes.

Insurance credit scoring is a way for insurers to automate their underwriting processes. Data are used to create a score – much like getting a grade in school. These scores are called “insurance credit scores” because the score is often a combination of several types of data, including:

- Credit history;
- Loss history; and
- Other personal attributes, such as the insured’s driving record.

The Issues

What Insurers say about Insurance Credit Scoring

Insurers say a correlation exists between credit history and insurance losses, and that this correlation justifies their use of insurance credit scoring. Other insurance industry arguments in favor of insurance credit scoring include:

- The use of credit information helps consumers who have good credit.
- Insurance credit scoring is “color blind” and does not discriminate against any protected class of people.
- There is no correlation between a person’s income and their insurance credit score. In other words, high income does not always lead to a good score and low income does not always lead to a lower insurance credit score.

What Consumer Groups say about Insurance Credit Scoring

Consumer groups generally oppose the use of credit history by insurance companies for underwriting and rating purposes. Some of their arguments against insurance credit scoring include:

- Data in credit reports are often inaccurate, and the process for correcting errors is cumbersome and time-consuming.
- There is considerable variation in the insurance credit scoring models, making it difficult for consumers to understand how insurance credit scoring works or how they can improve their scores.
- The models are confidential, and insurers and some vendors of insurance scoring models are not very forthcoming about data or formulas used in the models.
- The use of credit history in insurance underwriting and rating results in higher premiums for certain minority groups and low-income people.

Activity in Washington State

In the 1990's

In August of 1996, Commissioner Deborah Senn issued Bulletin 96-2,⁴ which instructed insurers to provide notice if they cancelled, denied or non-renewed insurance coverage based on credit history. This bulletin supported the provisions of the federal Fair Credit Reporting Act (FCRA), which requires insurers to provide notice when they take an adverse action against a consumer.

The bulletin, issued in response to consumer complaints, restated WAC 284-30-570,⁵ and reminded each insurer that it must provide the “true and actual reason” for an underwriting action, including actions based on credit information. The bulletin told insurers to provide specific information about the attributes in the consumer’s credit history that led to the adverse underwriting decision. The intent of the bulletin was to enable consumers to correct errors in their credit reports.

In 1996, the OIC had limited oversight over how insurers used credit history, since the federal FCRA allows insurers to use credit history for underwriting purposes. Without explicit statutory authority, such as that granted in ESHB 2544, it was up to the Federal Trade Commission (FTC) to determine whether insurers were providing inadequate notice.

Recent Activity

Consumer awareness of insurance credit scoring intensified when insurers began using it for rating purposes. In 2001, Commissioner Kreidler met with consumer advocates and the insurance industry to listen to their views on insurance credit scoring.

In the fall of 2001, the Commissioner held a series of public hearings across the state on insurance credit scoring. The Commissioner found overwhelming public concern about how insurers used credit history in underwriting and rating. Recurring themes that were cited in the public testimony included:

- Insurers would not explain how they used credit history or which pieces of the credit history were most important to their insurance scoring models. As a result, insurance agents felt helpless when a client had questions about how insurance credit scoring affected their premiums and consumers felt frustrated and confused.
- Consumers did not understand the relationship between credit history and the price they paid for auto or homeowners insurance.
- Personal crises, such as catastrophic medical bills, divorce and recent unemployment can cause credit problems. Consumers said it was unfair to be penalized with higher insurance premiums while working through a personal crisis.

⁴ <http://www.insurance.wa.gov/oicfiles/techadvisories/96-02.pdf>

⁵ <http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-30-570>

- Insurance scoring models penalized people who did not use credit. Ethnic groups and senior citizens said it was unfair to penalize a person who decides to manage their personal finances without borrowing money.
- Some people had no accidents, tickets or claims, but their insurance premiums went up or they were non-renewed based on their credit history.

The concerns expressed in these public hearings led to legislative action. In the 2002 legislative session, Commissioner Kreidler, Attorney General Christine Gregoire, and Governor Gary Locke jointly asked the Washington State Legislature to enact restrictions on the use of insurance credit scoring. In response, the Legislature enacted ESHB 2544. The law (codified in RCW 48.18.545⁶ and 48.19.035⁷) has several key provisions:

- It prohibits insurance companies from canceling or non-renewing a person's insurance policy because of an insurance credit score.
- It requires other significant underwriting factors to be present in addition to a poor insurance credit score in order to deny an application for insurance.
- It prohibits the use of certain factors in insurance credit scoring formulas. These factors include: The number of credit inquiries; medical collections; the initial purchase or finance of a vehicle or home; type of credit, debit, or charge card; total amount of available credit; and the lack of credit history (unless actuarially justified using demographic data).
- It requires retroactive correction of premium if the consumer successfully disputes information included on their credit report.

⁶ <http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section§ion=48.18.545>

⁷ <http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section§ion=48.19.035>

Recent Action by the States

The use of credit history by insurance companies to make pricing decisions caught the attention of the public, insurance regulators, legislators and the media. As insurers increased their use of insurance credit scoring, legislators have responded. States across the country have passed laws on this subject. In 2002, thirty state legislatures considered laws related to the use of credit information for insurance purposes. Eventually, eleven states, including Washington, passed new laws. Legislative activity continued in 2003, resulting in at least twenty-one new laws in various states related to insurance credit scoring.

Washington's 2002 law was one of the first and most comprehensive pieces of legislation to address the problems with insurance credit scoring. This law was drafted using many of the terms and concepts in the federal FCRA. Other states have followed Washington's example⁸ in key areas, including provisions that:

- Require insurers to retroactively correct premiums if an insurer uses incorrect credit history for rating or underwriting purposes.
- Require an insurer that takes an adverse underwriting or rating decision to tell the consumer about the most important factors in their credit history that lead to that decision.
- Require insurers to file their insurance scoring models with the respective insurance departments.
- Restrict the ability of an insurer to cancel or non-renew personal insurance based on credit history (although Washington's restrictions are tougher than most other states).
- Ban the use of credit inquiries and collection accounts identified with a medical industry code from insurance credit scoring models.

⁸ The National Conference of Insurance Legislators (NCOIL) adopted the Model Act Regarding Use of Credit Information in Personal Insurance. This model law contained a number of provisions from Washington's laws and regulations. It is available at <http://www.ncoil.org/>.

Activity by the National Association of Insurance Commissioners (NAIC)

The National Association of Insurance Commissioners (NAIC) has looked at this issue several times. In 1997, the NAIC issued a paper on insurance credit scoring. The report made recommendations, but did not result in any widespread changes to insurance regulatory practices related to insurance credit scoring.

In December of 2001, with the encouragement of Washington State, the NAIC formed a working group to study these issues. The Credit Scoring Working Group (CSWG)⁹ has continued to play a role in this debate. Commissioner Kreidler serves as co-chair of the CSWG. Significant accomplishments for the CSWG include:

- Working in partnership with the FTC to clarify that an insurer must send a notice if the insurer takes an adverse underwriting or rating action against a consumer.¹⁰ Insurers had argued that rating actions were not covered by the federal FCRA.
- Using the resources of the American Academy of Actuaries (AAA) to review, evaluate and comment on existing studies of insurance credit scoring.¹¹
- Developing a matrix of options for insurance regulators and legislators to consider as they work to solve issues that result from insurance credit scoring. The NAIC adopted this matrix, titled Analysis of Regulatory Options, on March 10, 2003.¹²
- Creating a brochure, titled Understanding How Insurers Use Credit Scoring, which was adopted by the NAIC on March 10, 2003. Based on this brochure, the OIC has updated its website¹³ to provide better information to consumers about insurance credit scoring.

The CSWG continues to look at the uses of insurance credit scoring and the potential for disparate or disproportionate impact on protected classes and low-income people. A small group of states, led by Missouri, is working to complete a study regarding the potential disparate impact of credit scores on protected classes of individuals. Washington State has provided technical assistance to this group as it has produced a study design to examine if insurance credit scores correlate with income or ethnicity. The FTC will likely review this design when it studies the effects of credit scoring on the availability and affordability of financial products, which is discussed in the next section of this report.

⁹ Information about current activities of the NAIC-CSWG can be found at http://www.naic.org/consumer_protection/htm_files/credit_scoring_wg.htm.

¹⁰ The FTC provided oral testimony at the NAIC winter 2002 meeting that affirmed the FTC's intent to adopt the interpretation of the FCRA presented in an informal staff opinion prepared by Hannah Stires. This opinion is available at <http://www.ftc.gov/os/statutes/fcra/ball.htm>.

¹¹ The report submitted by the AAA can be found at http://www.actuary.org/pdf/casualty/credit_dec02.pdf.

¹² http://www.naic.org/pressroom/releases/rel03/031003_credit_scoring_tools.doc

¹³ <http://www.insurance.wa.gov/factsheets/creditscoring.asp>

Recent Action by Congress

The federal FCRA (15 USC sec. 1681) was first enacted in 1970, and Congress has passed significant amendments in 1996, 1998 and 2003. The FCRA permits insurers to obtain consumer credit information for insurance underwriting purposes. When an adverse action is taken against a consumer based upon information in their credit report, the FCRA requires certain disclosures. Under existing law, the insurer must:

- Provide the consumer with the name, address, and telephone number of the consumer reporting agency that made the report;
- Tell the consumer of their right to obtain a free copy of the credit report; and
- Tell the consumer of their right to dispute the accuracy of the credit report.

This year, Congress passed HR 2622¹⁴ to reauthorize the FCRA on January 1, 2004. In response to public concerns about the use of credit history by financial institutions and the insurance industry, Congress has enacted some important new provisions. The following is a brief summary of some key amendments and how these changes will affect consumers in Washington State.

State Regulation of Credit-based Insurance Scoring is not Pre-empted by the FCRA¹⁵

HR 2622 does not limit, annul, affect, or supersede any state law regulating credit-based insurance scores used by insurers. This important amendment means that the provisions of Washington law will continue to protect consumers.

The FTC Must Study the Effects of Credit Scores and Credit-Based Insurance Scores on Availability and Affordability of Financial Products¹⁶

The new federal law requires the FTC to conduct a study of the effects of credit scores and credit-based insurance scores on the availability and affordability of financial products and services, including credit cards, mortgages, auto loans, and property and casualty insurance. The FTC must obtain public input on methodology and research design from state insurance regulators. The FTC study must examine:

- The statistical relationship between scores, quantifiable risks, and actual loss experience.
- Any negative or differential treatment of protected classes.

These questions are similar to those the Washington Legislature asked the OIC to answer in the first report to the Legislature. The OIC's answers were incomplete because the size of the data sample collected was comparatively small. However, the researcher's observation was that some minority groups tended to pay higher premiums. It is likely,

¹⁴ HR 2622 can be found at <http://thomas.loc.gov/>

¹⁵ Section 212 (e)(3)(C)

¹⁶ Section 215

since more data will be available, that the FTC study will answer the questions that the Legislature included in ESHB 2544.

Free Consumer Reports¹⁷

The new federal law requires nationwide consumer reporting agencies, including TransUnion, Experian, and Equifax, to provide free annual reports to consumers. This provision will enable consumers look at their credit report and correct data before it hurts their insurance credit score.

Credit Score Disclosure¹⁸

The new federal law requires mortgage lenders to disclose the credit score and up to four key factors that adversely affect the credit score. This provision is noteworthy because the FCRA will now require mortgage lenders to provide borrowers the same type of information that the Washington Legislature, when it enacted ESHB 2544, required insurers to provide to their customers.

Financial Institutions must Disclose when they make Negative Reports to a Consumer Reporting Agency¹⁹

The new federal law requires financial institutions to tell consumers that they are reporting negative information to a credit bureau. This provision should help consumers correct information earlier in the process.

Accuracy Guidelines and Regulations²⁰

The new federal law requires federal banking agencies, the National Credit Union Administration and the FTC to establish guidelines for the accuracy and integrity of credit information. Federal regulators must also publish regulations that tell a consumer how to dispute inaccurate information directly with the entity that provided the information.

Prompt Correction and Disclosure of Results of Reinvestigation²¹

The new federal law requires “prompt” deletion or modification of inaccurate information by credit bureaus. It also requires the entity that provided the credit information to delete promptly or modify and permanently block reporting of that information.

¹⁷ Section 211

¹⁸ Section 212

¹⁹ Section 217

²⁰ Section 312

²¹ Section 314

Reasonable Reinvestigation of Disputed Information²²

Additional amendments raise the standard on reinvestigations from merely “shall reinvestigate free of charge” to “shall, free of charge, conduct a reasonable reinvestigation.” This provides a stronger standard for enforcement by the FTC.

²² Section 317

Implementation of ESHB 2544

Rule-making

On July 3, 2002, Commissioner Kreidler began the rule-making process, seeking comments and feedback from insurers and the public. On September 6, 2002, after extensive comments from insurers, vendors of insurance scoring models and the public, the Commissioner adopted rules²³ to implement RCW 48.18.545²⁴ and RCW 48.19.035.²⁵ The rules describe standards that apply to personal lines insurers that use credit history for underwriting or rating purposes. More specifically, the rules:

- Define and further clarify various terms used in the law.
- Provide specific direction regarding the type and extent of the notice that an insurer must provide to consumers if the insurance company takes an adverse action against a consumer.
- Establish a process for insurers to follow when filing their insurance scoring models.
- Permit vendors that sell insurance scoring models to file those models on behalf of insurance companies.
- Establish procedures for insurers who elect to waive the confidentiality protection of the law and make their insurance scoring model a public document.
- Describe actions the Commissioner may take against an insurer that uses an illegal insurance scoring model.
- Direct insurers to submit specific types of data and statistical analyses if they use credit history in their rating plans.
- Provide guidance regarding when actuarial data based on demographic factors must be filed with the Commissioner.
- Provide a “Question and Answer” section that illustrates how the Commissioner would respond to various scenarios under the new law.

The OIC reviews insurance credit scoring models to ensure they do not contain credit attributes that are prohibited by law. As of Dec. 15, 2003, 184 insurance scoring models have been accepted by the OIC. However, fewer insurance scoring models are being used by insurers than this statistic suggests, since many insurers simply adopted models filed by Fair Isaac and Choice Point. This statistic points to a success in the rule-making process: WAC 284-24A-025 explicitly allows vendors of insurance credit scoring to file models. This rule reduced the costs -- in terms of time and expense -- to implement the law.

²³ <http://www.leg.wa.gov/wac/index.cfm?fuseaction=chapterdigest&chapter=284-24A>

²⁴ <http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section§ion=48.18.545>

²⁵ <http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section§ion=48.19.035>

Of the rules filed, only WAC 284-24A-055 appears to be ineffective. This rule requires specific types of demographic data if an insurer wants to charge different premium based on a “no hit” or “no score” -- which translates to lack of credit history. Data requested in this rule, which was an attempt to implement RCW 48.19.035(3)(a),²⁶ are too sparse to provide useful information. In 2004, the OIC will begin the rule-making process and consider amending this section of the rule and the definition of “demographic factors”²⁷ to require insurers to submit statistics in larger data sets.

²⁶ (3) Insurers shall not use the following types of credit history to calculate a personal insurance score or determine personal insurance premiums or rates:

(a) The absence of credit history or the inability to determine the consumer's credit history, unless the insurer has filed actuarial data segmented by demographic factors in a manner prescribed by the commissioner that demonstrates compliance with RCW 48.19.020; . . .

²⁷ <http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-005>

The Filing Process

Fair Isaac and ChoicePoint are companies that sell credit-based insurance scoring models to insurance companies. OIC began discussions with these companies in July 2002, shortly after the rule-making process began. Fair Isaac and ChoicePoint filed their insurance scoring models in September 2002, and both models were accepted by the OIC in October of 2002.

Most insurers that use insurance credit scoring for underwriting met the January 1, 2003 filing deadline. Insurers that use insurance credit scoring for rating purposes were slower in filing their models and rating plans. In January 2003, the OIC became concerned that there would be a large number of personal lines insurers out of compliance with the law by June 30, 2003. On January 16, 2003, the Commissioner issued Technical Assistance Advisory T-03-01,²⁸ which advised insurers to submit revised rating plans before February 28, 2003. The OIC suggested this timeline due to these factors:

- The OIC expected the normal review time might increase if a large number of insurers filed rating plans at one time and, presumably, close to the law's effective date of June 30, 2003.
- The OIC knew insurers need time to program computer systems when they change rates or rating plans. Lead-time of three to six weeks is common to program changes that affect renewals.
- Many insurers process renewals 45 days in advance of the renewal date, which means an insurer would have to complete all programming by May 15, 2003 to meet a June 30, 2003 effective date.
- Between programming time and the renewal-processing period, the OIC thought that many insurers would have to have their rating plan approved by April 2003.

The Technical Advisory worked. Insurers began filing their insurance scoring models and rating plans. The OIC worked with insurance companies to resolve compliance issues. Other steps the OIC's Rates and Forms Division took to speed the review process included:

- Prioritizing insurance scoring models and rating plans to the highest level.
- Communicating by e-mail and over the telephone when additional data or changes were needed to bring the filing into compliance with the law.
- Working collaboratively with the Association of Insurance Compliance Professionals to notify their members of the law and its requirements.

As of December 15, 2003, OIC has approved 118 rate filings that comply with our laws and rules. A few insurers missed the June 30 date, and the OIC initiated two disciplinary actions. The facts alleged by the OIC in these cases include:

²⁸ <http://www.insurance.wa.gov/oicfiles/techadvisories/T03-01.pdf>

1. An insurer renewed 1,937 boat insurance policies after June 30, 2003 using rates based on an insurance scoring model that had not been filed with the OIC. The OIC believes the credit scoring laws apply to personal inland marine insurance²⁹ including boat owner's insurance. The OIC believes the insurer was in violation of the credit scoring law³⁰ and administrative rules³¹ between June 30, 2003, and August 9, 2003.
2. A company had used a credit based "financial stability score" since January 1, 2003 to assign applicants for homeowners insurance to a particular rating tier. The scoring algorithm had not been filed with the OIC, as required by RCW 48.19.040. The OIC believes the insurer was in violation of the law from June 30, 2003 until October 20, 2003, which is the date rates derived from a filed insurance credit scoring model were approved by the OIC.

²⁹ See RCW 48.19.035(1) (d)(vi).

³⁰ See RCW 48.19.035(2).

³¹ See WAC 284-24A-015(2).

Ambiguity in the Credit Scoring Law

During the implementation process, the OIC's Rates and Forms Division determined that one section of RCW 48.19.035 is not clear. This ambiguity, if not corrected, has the potential to create an "uneven playing field" that favors insurance holding companies or organizations that sell personal lines insurance using more than one company (insurer). Generally, there are three common methods of marketing personal lines insurance:

1. Operating with one insurance company and selling insurance to a narrowly defined target market.
2. Operating with one insurance company and selling insurance to a broadly defined target market using rating tiers.³² Rating tiers allow an insurance company to have several price levels to insure people with a variety of risk characteristics.
3. Operating through a group of affiliated insurance companies and selling insurance to a broadly defined target market using different price structures in each company. This structure allows an insurance holding company or organization to have several price levels to insure people with a variety of risk characteristics.

A few insurance organizations operating under the third structure have argued that they use insurance credit scoring only for underwriting – which means placement in a particular company based on the risk characteristics of the individual. They contend they should not have to file their credit-based rating plans with the OIC. The OIC disagrees, for several reasons:

- The OIC believes the Legislature intended to require every insurance holding company or organization to file their credit-based rating plans and provide complete actuarial support for those plans. Any other outcome provides an unfair competitive advantage to insurance organizations that sell products through affiliated companies.
- Underwriting and rating are linked processes. An insurer does not decide how much premium to charge an individual until it evaluates that person's risk profile. To imply that affiliated companies are not using insurance credit scoring to make pricing decisions is inaccurate based on the "real world" practices of the insurance industry.

To clear up any ambiguity in the law, the OIC will propose an amendment to RCW 48.19.035. The key component of the proposed amendment (which begins on page 28 of this report) will explicitly state:

Each insurer that uses credit history or an insurance score to determine personal insurance rates, premiums, or eligibility for coverage must file all rates and rating plans with the commissioner. This requirement applies equally to a single insurer and two or more affiliated insurers.

³² RCW 48.18.545(1) (h) says: "Tier" means a category within a single insurer into which insureds with substantially like insuring, risk or exposure factors, and expense elements are placed for purposes of determining rate or premium.

To date, the vast majority of insurers have filed their rating plans in a manner consistent with the intent of the Legislature. The Commissioner respectfully asks for the Legislature's favorable consideration of this amendment so that all insurance companies can compete using the same set of rules.

How ESHB 2544 has Impacted Consumers

Rates and Rating Plans

Generally, personal lines insurance rates did not change much after the rating piece of the law took effect on June 30, 2003. While rates remained stable, premiums for individual consumers may have changed after insurers filed new rating plans. Some of these rating plans were filed to comply with the law, and others were filed to implement the business or marketing plan of the individual insurer. It would be impossible to isolate or speculate how the law influenced the business decisions made by over one hundred insurance companies.

Personal lines insurance rating plans are very complex. Most insurers start out with an insurance rate, and then multiply that rate by rating factors contained in their rating plan. This is why premiums can vary greatly among different policyholders. The complexity is increasing as insurers add more rating factors based on both personal characteristics of the insured and the nature of the risk.

Some common components of an automobile insurance rating plan include:

- Territory rating factors (based on the address of the insured).
- Credit based rating factors.
- Discounts based on the composition of the family (married, single, children in the household).
- Sports car surcharges (based on the performance characteristics of car).
- Driver class rating factors (based on the age and sex of the driver).
- A surcharge if the driver is inexperienced (based on the years of driving experience).
- Multi-car discounts.
- Account (auto/home) discounts.
- Merit (or rather, de-merit) plans for tickets and accidents.
- A surcharge if a personal car is used for business purposes.

For a number of insurers, the list of rating factors is much longer. The Commissioner is responsible for reviewing rates and rating plans to ensure that the resulting premium rates for insurance are not excessive, inadequate or unfairly discriminatory.³³ With the complexity of modern rating plans, the Commissioner must look for modern ways of examining data to make sure that the OIC is fulfilling its mission.³⁴

³³ See RCW 48.19.020.

³⁴ The OIC's mission is: "We protect consumers, the public interest, and our state's economy through fair and efficient regulation of the insurance industry."

The Commissioner is determined to ensure that insurance companies do not use insurance credit scoring to raise premiums for consumers unfairly.³⁵ The Commissioner's question to the insurance industry is simple: When applied in combination with other elements of a rating plan, does insurance credit scoring "double count" for factors already considered somewhere else in that rating plan?

An example may illustrate the OIC's concern. Young drivers are often surcharged based on age (by application of a driver class factor) or driving experience (by application of an inexperienced operator surcharge). Young people are also more likely to have lower insurance credit scores or no credit history. If an insurer increases premium based on age and driving experience, should they also increase premiums due to credit history?

To answer these types of questions, the Commissioner issued Technical Assistance Advisory T 01-02,³⁶ and adopted WAC 284-24A-045³⁷ and WAC 284-24A-050.³⁸ Insurers are now required to submit a multivariate analysis if the insurer uses credit history to segment and rate personal insurance business. In simple terms, a multivariate analysis tests other rating variables simultaneously with credit history to adjust for any interrelationship between insurance credit scores and other risk factors. Multivariate analysis isolates the effect of credit history on insurance losses independent of other rating variables.³⁹

Some insurers have used multivariate analysis for years to refine their rating plans. They believe this tool is critical to accurate pricing. Not surprisingly, insurers who have not used this analytical tool in the past have discovered that their rating plans need some adjustments. Common areas where multivariate analysis suggests some rating plans may need changes include:

- Vehicle use (some insurers may not be charging enough premium for commute and business use).
- Territory (some insurers may need to re-vamp their territory rating factors).
- Age of driver (elderly drivers – particularly those over 75 years old – are showing adverse loss trends).
- Multi-car and account discounts (some insurers may need to adjust these discounts).

³⁵ The standard for insurance rates in Washington (and many other states) is included in RCW 48.19.020. This law says that "Premium rates for insurance shall not be excessive, inadequate or unfairly discriminatory."

³⁶ <http://www.insurance.wa.gov/oicfiles/techadvisories/T01-02.pdf>

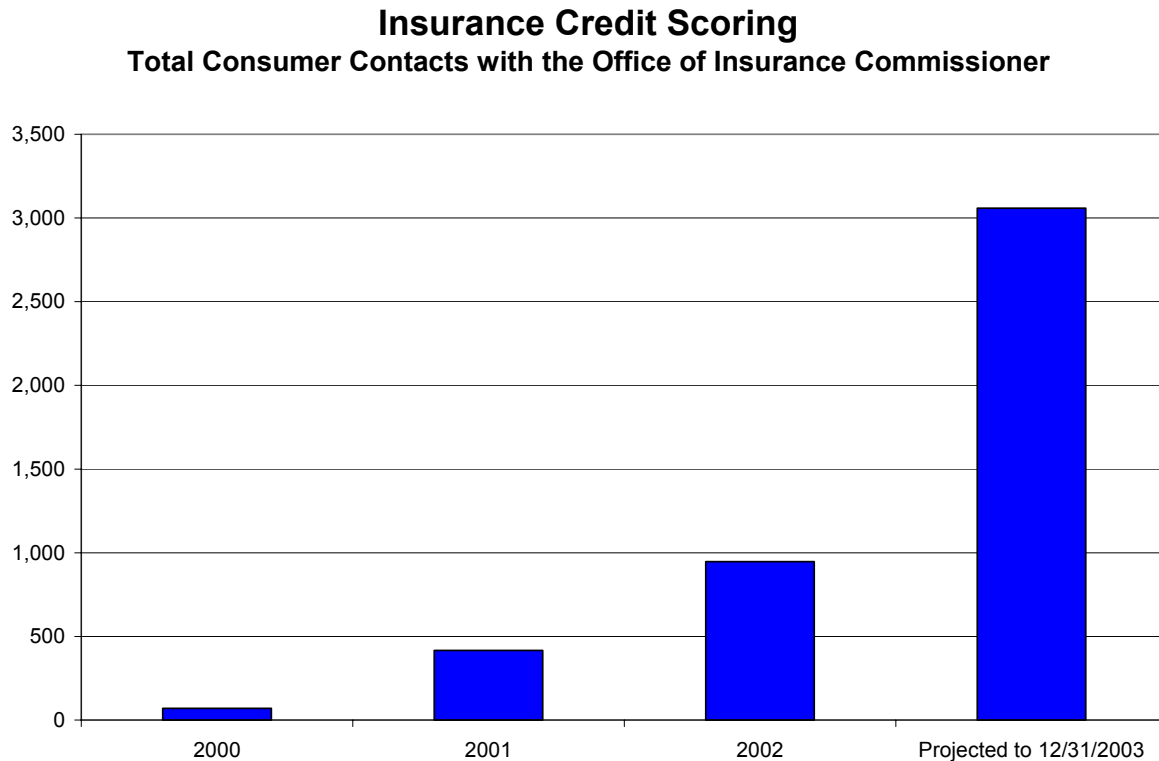
³⁷ <http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-045>

³⁸ <http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-050>

³⁹ In August 2002, the OIC participated in two seminars explaining Washington's Credit Scoring Laws. The presentation materials of Pinnacle Actuarial Resources (PAR) may help explain some of the pricing issues that occur when an insurer adds insurance credit scoring to the mix. This is not an endorsement of PAR's products or services. The presentation can be found at <http://www.pinnacleactuarialresources.com/pages/services/Pinnacle%20WA%20Presentations.pdf>.

What Consumers are Saying

By year-end 2003, the OIC will have received an estimated 4,493 contacts from consumers about insurance credit scoring over the last four years.⁴⁰ Sixty-eight percent (68%) of these contacts occurred in 2003.



Very few of the contacts were from happy consumers. The OIC believes the notice requirement in the law is one reason the contacts have increased in 2003. The law requires that insurers provide up to four reasons the consumer is not receiving the lowest rate for insurance. This law is not unique to Washington State -- it is part of the NCOIL model law and new FTC requirements for mortgage lenders. Some observations:

OIC believes some insurers were not providing “adverse action” notices under the FCRA before Washington’s credit scoring law took effect.

In OIC’s opinion, the federal FCRA has always required insurers to provide an adverse action notice. The OIC does not believe that all insurers were providing notice under the FCRA before ESHB 2544 took effect. Once state law required notice, insurers became more diligent about sending adverse action notices. Now, consumers are more aware that credit history is affecting their insurance premiums.

⁴⁰ Data from calendar year 2000 through November 2003, projected to year-end 2003. The breakdown is 298 formal complaints based on an alleged violation of law, 585 letters requesting information and 3610 telephone calls.

Insurers are adding more complexity to their rating plans and product lines.

More insurers are using credit history for pricing and market segmentation. This is called “tiering,” where consumers are placed in rating tiers based on their insurance credit score. Each rating tier has a different price level.

At least one insurer in Washington has an auto insurance product that has 50 rating tiers. Only a handful of customers will qualify for the lowest rate, and the rest of their customers will receive “adverse action” notices. Even if the insurance premium differential is small, these notices still tell a customer that they have a problem with their credit history.

The notices provided by some insurers do not give useful information.

Insurers must provide up to four reasons why a consumer is not eligible for the lowest price.⁴¹ Often, the reasons are cryptic and hard for the consumer to understand. These are typical reasons consumers are told their insurance credit scores could be better:

1. Absence of revolving credit account. Intuition may tell a consumer that opening a revolving credit account would improve their score. However, applying for new credit often lowers the insurance credit score.
2. Age of oldest account or revolving credit account. If questioned, insurers may tell the consumer that holding on to a credit card for a long time improves their score. On the other hand, this may mean the consumer must keep a credit card that they no longer want to use.
3. Age that consumer first opened a credit account. This means a consumer who opens a credit account early in life will get a better insurance credit score. This attribute may have negative implications for people who immigrate to this country. A person who immigrates to this country after their teens may always get a lower insurance credit score – no matter how well they manage their credit.
4. Unfavorable number of bank or revolving accounts. Consumers are often left to wonder what constitutes a good number of bank or revolving accounts.
5. Debt ratio (ratio of debt to credit limits). This ratio measures how much money a consumer borrows as compared to their available credit limits. Intuition may tell a consumer that opening a revolving credit account would improve their score by driving down this ratio. However, applying for new credit often lowers the insurance credit score.
6. Number of accounts opened in past year. Consumers are often left to wonder how many accounts are too many accounts.

Insurers also provide reasons related to account delinquencies, past-due payments, collection activity, and public records, such as bankruptcy. These reasons seem to be better understood by consumers.

⁴¹ <http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-010>

WAC 284-24A-010(2) requires insurers to provide clear information to consumers about the factors that adversely affect their credit history or insurance credit score.⁴² OIC has received a number of complaints from consumers about adverse action notices sent by insurance companies. Many of the complaints are about the content of the adverse action notice. The basis for many of these complaints is the consumer's inability to determine which attributes on their credit report caused their insurance credit score to be less than perfect.

The OIC is currently reviewing a sample of complaint files to determine whether any laws or regulations have been violated. OIC is committed to working with insurers and vendors of insurance scoring models to improve the adverse action notices so that consumers have better information about the elements of their credit report that cause insurers to increase premiums.

Insurers do not provide advice to help consumers improve their insurance credit scores.

Insurers are not as experienced as lenders in explaining how credit history affects the price of their products. The OIC also believes that some insurers that buy insurance scoring models from vendors do not know what is in the "black box." Many of the contacts the OIC receives from consumers result from insurer's lack of knowledge about this scoring tool. Either the insurers or agents cannot explain the information on the adverse action notices or they cannot help consumers improve their insurance credit scores. The OIC believes insurers should provide both of these services.

⁴² WAC 284-24A-010 What must an insurer tell a consumer when it takes an adverse action? (1) An insurer must tell a consumer about significant factors that adversely affect the consumer's credit history or insurance score. As many as four factors may be needed to explain the adverse action.

(2) An insurer must explain what significant factors led to an adverse action in clear and simple language.

(3) An insurer may choose to tell consumers which factors positively affect a consumer's credit history or insurance score.

Other Issues: Confidentiality of Insurance Scoring Models

The OIC is growing more concerned about the confidentiality protections included in RCW 48.19.035(2). When the law was first enacted, the OIC believed the intent of the Legislature was to protect the intellectual property contained in the insurance scoring models. At that time, the models primarily contained credit history. For a number of insurers, this is no longer true.

It is becoming more common to include other rating variables in insurance scoring models. The OIC has received insurance scoring models that include rating variables such as:

- Age and marital status.
- Home ownership.
- Limits of coverage.
- Claim data.

If an insurer incorporates common or “traditional” rating and underwriting variables into the insurance scoring model, it can shield that information from both its competitors and public. The OIC believes the public’s right to know how insurers determine personal insurance premiums outweighs the insurers’ need to protect intellectual property included in the insurance scoring models.

The confidentiality provision of the law restricts the ability of the Commissioner to educate consumers about insurance credit scoring. The OIC would like to provide more advice to consumers. The OIC would like to explain which factors are contained in the insurance scoring models and how consumers can improve their insurance credit scores. The confidentiality provisions in RCW 48.19.035(2) prevent the OIC from fulfilling one of its fundamental strategic objectives -- to protect and educate consumers.

Recommendations

Amend the Credit Scoring Law to Level the Playing Field

The OIC hopes the 2004 Legislature will favorably consider the proposed amendment to the credit scoring law, which begins on page 28 of this report. This amendment will ensure that all companies that choose to use credit history to develop rating plans must:

- File those plans with the Commissioner;
- Provide appropriate actuarial and statistical support for those rating plans; and
- Operate on a level playing field with their competitors.

Review the Confidentiality Protections for Insurance Scoring Models

The OIC will continue to monitor how the confidentiality protections under RCW 48.19.035(2) are affecting consumers. The OIC may make specific recommendations for legislation in the future.

Proposed Revision to the Insurance Credit Scoring Law

AN ACT requiring all insurers to file credit based rating plans; amending RCW 48.19.035.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

SEC. 1. RCW 48.19.035 and 2002 c 360 § 2 is amended as follows:

(1) For the purposes of this section:

(a) "Affiliate" has the same meaning as defined in RCW 48.31B.005(1).

~~((a))~~ (b) "Consumer" means an individual policyholder or applicant for insurance.

~~((b))~~ (c) "Credit history" means any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's creditworthiness, credit standing, or credit capacity that is used or expected to be used, or collected in whole or in part, for the purpose of serving as a factor in determining personal insurance premiums or eligibility for coverage.

~~((c))~~ (d) "Insurance score" means a number or rating that is derived from an algorithm, computer application, model, or other process that is based in whole or in part on credit history.

~~((d))~~ (e) "Personal insurance" means:

(i) Private passenger automobile coverage;

(ii) Homeowner's coverage, including mobile homeowners, manufactured homeowners, condominium owners, and renter's coverage;

(iii) Dwelling property coverage;

(iv) Earthquake coverage for a residence or personal property;

(v) Personal liability and theft coverage;

(vi) Personal inland marine coverage; and

(vii) Mechanical breakdown coverage for personal auto or home appliances.

(2) (a) Credit history shall not be used to determine personal insurance rates, premiums, or eligibility for coverage unless the insurance scoring models are filed with the commissioner. Insurance scoring models include all attributes and factors used in the

calculation of an insurance score. RCW 48.19.040(5) does not apply to any information filed under this subsection, and the information shall be withheld from public inspection and kept confidential by the commissioner. All information filed under this subsection shall be considered trade secrets under RCW 48.02.120(3). Information filed under this subsection may be made public by the commissioner for the sole purpose of enforcement actions taken by the commissioner.

(b) Each insurer that uses credit history or an insurance score to determine personal insurance rates, premiums, or eligibility for coverage must file all rates and rating plans with the commissioner. This requirement applies equally to a single insurer and two or more affiliated insurers. RCW 48.19.040(5) applies to information filed under this subsection.

(3) Insurers shall not use the following types of credit history to calculate a personal insurance score or determine personal insurance premiums or rates:

(a) The absence of credit history or the inability to determine the consumer's credit history, unless the insurer has filed actuarial data segmented by demographic factors in a manner prescribed by the commissioner that demonstrates compliance with RCW 48.19.020;

(b) The number of credit inquiries;

(c) Credit history or an insurance score based on collection accounts identified with a medical industry code;

(d) The initial purchase or finance of a vehicle or house that adds a new loan to the consumer's existing credit history, if evident from the consumer report; however, an insurer may consider the bill payment history of any loan, the total number of loans, or both;

(e) The consumer's use of a particular type of credit card, charge card, or debit card; or

(f) The consumer's total available line of credit; however, an insurer may consider the total amount of outstanding debt in relation to the total available line of credit.

(4) If a consumer is charged higher premiums due to disputed credit history, the insurer shall rerate the policy retroactive to the effective date of the current policy term. As rerated, the consumer shall be charged the same premiums they would have been

charged if accurate credit history was used to calculate an insurance score. This subsection applies only if the consumer resolves the dispute under the process set forth in the fair credit reporting act and notifies the insurer in writing that the dispute has been resolved.

(5) The commissioner may adopt rules to implement this section.

(6) This section applies to all personal insurance policies issued or renewed on or after June 30, 2003.